IN THE

# Supreme Court of the United States

OCTOBER TERM, 1977

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No. 1088

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CHESTNUTT CORPORATION,

*Petitioner,*

*v.*

MILDRED GALFAND,

*and*

AMERICAN INVESTORS FUND, INC.,

*Respondents.*

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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## BRIEF FOR RESPONDENT MILDRED GALFAND IN OPPOSITION

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### Opinions Below

The relevant opinions below are the opinions of the Court of Appeals for the Second Circuit reported at 545 F.2d 807 (App. E of Petition) affirming as modified as to damages the opinion of the District Court of the Southern District of New York reported at 402 F. Supp. 1318 (App. D of Petition).

## Jurisdiction

The jurisdictional requisites are adequately set forth in the petition.

## Statutes and Regulations Involved

Section 36(b) of the Investment Company Act of 1940, 15 U.S.C. § 80(a)-35(b).

Section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(a) and Rule 14a-9, 17 C.F.R. § 240.14a-9(a) promulgated by the S.E.C.

Section 20(a) of the Investment Company Act, 15 U.S.C. § 80a-20(a) and Rule 20a-1, 17 C.F.R. § 270.20a-1 promulgated by the S.E.C.

## Statement of the Case

This is a derivative action on behalf of American Investors Fund, Inc. ("AIF") (a respondent herein), a New York corporation, registered pursuant to the Investment Company Act of 1940 ("the Act") as an open-end diversified investment company, and commonly known as a mutual fund. The defendants below were Chestnutt Corp. (the petitioner herein), the investment adviser to AIF, and George A. Chestnutt, Jr., the principal shareholder of Chestnutt Corp.

The essence of the claim was a wrongful mid-term change in the advisory agreement under which Chestnutt Corp. served as an investment adviser to AIF. The change increased a guaranteed annual expense limitation for AIF from 1% of AIF's average monthly net assets to 1½% of AIF's average monthly net assets. The effect of the increase was to deprive AIF of a refund or rebate, from Chestnutt Corp. for the amount that AIF's expenses exceeded 1% for the period in issue.



The Court of Appeals for the Second Circuit affirmed the decision of the District Court for the Southern District of New York and a judgment for $145,072 in favor of AIF and against Chestnutt Corp. has been entered.

Chestnutt Corp., or its predecessor, had served as investment adviser to AIF since AIF's formation in 1957. In the spring of 1973, it was serving as investment adviser to AIF pursuant to an advisory contract dated as of September 1, 1972 ("Old Advisory Contract"). The Old Advisory Contract, by paragraph 11, provided for a term of two years from September 1, 1972, but could be sooner terminated by either AIF or Chestnutt Corp. on 60 days written notice.

Under the Old Advisory Contract, Chestnutt Corp. agreed to provide AIF with, among other things, research, statistical and advisory services, office space, clerical and mailing services and payment of all AIF executive salaries. For this, Chestnutt Corp. was to receive, as an advisory fee, a fixed percentage of AIF's average monthly net assets. The specific fee payable under the Old Advisory Agreement was .8 of 1% on the first $50 million of AIF's average monthly net assets, .6 of 1% on the next $50 million, .4 of 1% on the next $200 million, .35 of 1% on the next $200 million and .3 of 1% on all amounts in excess of $500 million. This advisory fee, however, was subject to a 1% expense limitation. The expense limitation required Chestnutt Corp. to rebate to AIF all amounts by which the expenses of AIF, net of interest and taxes but including the advisory fee, exceeded 1% of AIF's average monthly net assets for any year.*

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* The Old Advisory Contract, after setting out the compensation to Chestnutt Corp., stated:

> "provided, however, that the annual fee of the Investment Adviser shall not be more than an amount which, when added to the other charges of the Corporation (exclusive of inter-

*(footnote continued on following page)*

In the spring of 1973, while the Old Advisory Contract had more than one year to run, defendants Chestnutt Corp. and George A. Chestnutt, Jr. acted to replace the existing agreement with a new advisory contract. The new agreement ("New Advisory Contract") was identical in all respects to the Old Advisory Contract except that the expense limitation was increased from 1% to 1½% of average monthly net assets.

Plaintiff challenged the increase in the expense limitation and sought to recover the rebate for AIF. The Court of Appeals for the Second Circuit found for plaintiff on two separate and independent grounds. The Court concluded that Chestnutt Corp. violated Section 36(b) Investment Company Act, 15 U.S.C. § 80a-35(b) by the manner in which it acted to obtain AIF board approval for the change and then subsequently violated S.E.C. Rule 14a-9 in soliciting shareholder approval for the revised advisory contract.

## Argument

The issues presented by this case are not appropriate for review by this Court since they arise under unique facts, unlikely to recur. The Court of Appeals for the Second Circuit held that:

> ". . . Chestnutt Corporation abused its position of trust by acquiring from the mutual fund, without full disclosure to the AIF Board of Directors, a patently one-sided revision of the advisory contract and that it subsequently violated Rule 14a-9 in obtaining shareholder ratification of the new contract on the basis of a misleading proxy statement." (Petition, App. E., Page 55a).

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*(footnote continued from preceding page)*

est and taxes) shall result in total charges per annum to the Corporation inclusive of the fee of the Investment Advisor (but exclusive of interest and taxes) of 1% of the value of the Corporation's average monthly net assets for any year."



The fact that the decision below was based on two grounds, each independently sufficient to sustain the decision, and each based on unique and non-recurring facts, makes additional judicial review unwarranted.•

## POINT I

### The Court Below Properly Applied This Court's Decision In *TSC Industries, Inc.* v. *Northway, Inc.*

The decision of the district court in this matter finding the AIF proxy statement deficient was written prior to the Supreme Court opinion in *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438 (1976) which refined the test for materiality. The Court of Appeals, however, specifically considered the proxy material found offending by the district court and applied the *TSC Industries, Inc.* test to it. The Court of Appeals stated:

> "We are of the view that even under the *TSC Industries* test, the proxy statement here was materially misleading." (Petition, App. E., Page 64a).

Thus, petitioners' position that this case "cannot be reconciled with *TSC Industries, Inc.* v. *Northway, Inc.*" (Petition, Page 26), is clearly incorrect.

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• Chestnutt Corp. has had ample judicial review of this matter in that the merits were before the Court of Appeals twice and *en banc* consideration was requested and denied on both appeals. The Court, in fact, found that the second attempt to argue the merits rendered the appeal frivolous and assessed double costs. (Petition, App. G., Pages 72a-73a).

## POINT II

**The Court's Findings That Chestnutt Corporation Breached Its Fiduciary Duties To The Fund Should Not Be Reviewed.**

The district court and the Court of Appeals, both, after extensive recitation of the facts, found that Chestnutt Corp. breached its fiduciary duties to the fund by acting to replace the advisory agreement and thereby deprive AIF of a rebate. Both courts were emphatic in recognizing that the conduct employed by Mr. Chestnutt and Chestnutt Corp. in seeking to change the contract was far outside of the range of conduct expected of a fiduciary. The Court of Appeals specifically found:

> ". . . Chestnutt appears to have ignored completely his duty to promote responsible directorial judgment by supplying information sufficient to enable the Fund's Board to evaluate the new contract 'with an eye eager to discern . . . rather than shut against' the interests of AIF. *Fogel* v. *Chestnutt, supra* at 749. His influence with the Fund's directors can hardly be questioned. The result of this dereliction was a patently one-sided revision of the advisory contract which placed the entire burden of rising costs and a falling market on the Fund, whose financial condition was not accorded even a passing concern." (Petition, App. E, Page 61a).

There is no strong public policy or precedent setting value in the Supreme Court reviewing these facts. Although there is indeed the $50 billion mutual fund industry with many hundreds of funds and advisers as petitioner suggests (Petition, Page 23) there is little reason to expect that the outcome of this case will affect in any way whatsoever the conduct of any other adviser or any other mutual fund.



The simple fact is, as found by the District Court and the Court of Appeals, that Chestnutt Corp. sought personal gain at the expense of the fund in a manner offensive to any minimum standard expected of a fiduciary.

## CONCLUSION

**For the foregoing reasons, it is respectfully submitted that the petition for a writ of certiorari should be denied.**

Respectfully submitted,

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